

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

THE BENNETT FUNDING GROUP, INC.

Debtors

CASE NO. 96-61376

Chapter 11

Substantively Consolidated

RICHARD C. BREEDEN, TRUSTEE OF THE
BENNETT FUNDING GROUP, INC., ET AL

Plaintiffs

vs.

ADV. PRO. NO. 98-70474A

FREEPORT SHIPBUILDING & MARINE
REPAIR, INC.

Defendant

APPEARANCES:

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Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT,
CONCLUSIONS OF LAW AND ORDER

The Court has before it a motion filed on July 17, 1998, on behalf of Freeport Shipbuilding & Marine Repair, Inc. ("Freeport") seeking an order compelling arbitration of certain causes of action set forth in a complaint filed by Richard C. Breeden, chapter 11 trustee

(“Trustee”) of the substantively consolidated estates of The Bennett Funding Group, Inc. (“BFG”), Bennett Receivables Corporation (“BRC”), Bennett Receivables Corporation II (“BRC-II”), Bennett Management & Development Corporation (“BMDC”), The Processing Center, Inc. (“TPC”), Resort Service Company, Inc. (“RSC”), American Marine International, Ltd. (“AMI”) and Aloha Capital Corporation (“Aloha”) (the “Debtors”), pursuant to Rule 9019(c) of the Federal Rules of Bankruptcy Procedure (“Fed.R.Bankr.P.”) or in accordance with the terms of a construction contract executed by Freeport and BMDC on or about January 7, 1994 (“Contract”). In the alternative, Freeport requests that the Court exercise its discretion and order certain breach of contract claims found in the Trustee’s complaint to arbitration. The Trustee filed opposition to Freeport’s motion on September 4, 1998.

The motion was originally heard on September 10, 1998, in Utica, New York, and was adjourned to September 24, 1998, to allow the parties an opportunity to file supplemental memoranda of law. At the hearing on September 24, 1998, the Court granted Freeport’s motion from the bench and ordered that the breach of contract causes of action be sent to arbitration pursuant to the terms of the Contract based on a finding that the Trustee had failed to establish any fundamental policies of the Code that would preclude such relief.

At the time of the hearing on September 24, 1998, the Court was under the mistaken impression that the Trustee had elected not to file a supplemental memorandum of law. Subsequent to the hearing, it became aware of an argument raised by the Trustee in correspondence filed with the Court on September 21, 1998, and described therein as a “supplemental letter brief” (“Letter Brief”). The Court made the decision to vacate its prior oral order and return the motion to the Court’s calendar on October 8, 1998, in order to afford the

parties an opportunity to address the Trustee's argument that Freeport waived its right to enforce the Contract's arbitration clause as a result of a Consent Order signed by the Court on January 28, 1997. *See* Exhibit "C" ("Consent Order") attached to Affirmation of Eileen P. Kennedy, Esq., filed September 4, 1998.

JURISDICTIONAL STATEMENT

The Court has jurisdiction over the parties and subject matter of this adversary proceeding pursuant to 28 U.S.C. §§ 1334(b), 157(a), (b)(1), (b)(2)(A) and (O).

FACTS

On or about January 7, 1994, Freeport and BMDC entered into the Contract for the construction of a gambling vessel known as the "Speculator."¹ Included in the Contract is a provision which states,

Any controversy, dispute or claim arising out of or relating to this Agreement, or the breach thereof, shall be settled by arbitration administered by the American Arbitration Association in accordance with its commercial arbitration rules, and judgment on the award rendered by the arbitrators may be entered in any Court having jurisdiction thereof. It is mutually agreed that Fort Walton Beach, Florida, shall be designated as the place for the conduct of any such arbitration. It is agreed that any arbitration hereunder shall be by a panel of three (3) arbitrators.

See Exhibit "A" of Freeport's Motion at Section X.

¹ By an assignment dated December 31, 1994, BMDC allegedly assigned the Contract and its rights to the Speculator to BFG, which in turn assigned the Contract and its rights to the vessel to AMI. *See* Trustee's Motion, filed November 27, 1996 ("Transport Motion") at ¶ 2.

On November 5, 1996, Freeport filed a motion seeking to compel the Trustee to assume or reject the Contract pursuant to Code § 365(a) and in the interim to make certain maintenance and insurance payments. On the same date, Freeport also filed a motion for allowance and payment of an administrative claim. On November 27, 1996, the Trustee filed a motion seeking authority to expend funds of BFG to transport the Speculator to another location and to cover the costs associated with the ongoing service and maintenance of the Speculator (“Transport Motion”).

In the Transport Motion, the Trustee indicated his wish to move the Speculator from Freeport’s facility to an alternate site. Freeport expressed reluctance to allow the Speculator to leave its facility until the Trustee had assumed the Contract and complied with Code § 365, including curing any and all defaults. The Trustee alleged that he had been advised “that significant amounts that had been invoiced by Freeport Shipping in connection with the pre-petition construction appear to have been paid for under earlier invoices. In addition, it appears from an initial review of the vessel that a comprehensive comparison of the material called for by the specifications and those that were actually installed on the Speculator should be undertaken.” *See* Transport Motion at ¶ 13. The Trustee stated that he “would be willing to pay such amounts as the parties can reasonably agree from the proceeds of the sale of The Speculator, subject to Court approval. If the parties are unable to agree on the appropriate amounts, the Trustee will escrow the disputed amount and submit the dispute to the Court for final adjudication.” *See id.* at ¶ 14.

The parties agreed to resolve all three motions pursuant to the terms set forth in the Consent Order. According to the terms of the Consent Order, Freeport was granted a post-

petition administrative claim for the costs and expenses of insurance, electricity, elevator maintenance, security and fuel incurred by Freeport as of November 30, 1996. The Trustee agreed to pay 50% of Freeport's claim on the first business day after entry of the Consent Order. *See* Consent Order at ¶ 1(b). The remaining 50% was to be paid on the first business day after March 1, 1997. *See id.* at ¶ 1(c). Neither payment was made contingent on the sale of the vessel. The Trustee was also authorized to transport the Speculator "to a suitable port for mooring and marketing." *See id.* at ¶ 2(a).

Paragraph 3 of the Consent Order provides for the assumption of the Contract as modified by the terms found in the Consent Order. According to ¶ 3(b), Freeport's prepetition claim of \$350,000² was to be treated as follows: Freeport was granted a lien on the Speculator for its prepetition, as well as postpetition administrative, claims. That lien was to be released upon approval by the Court of the sale of the Speculator.³ *See id.* at ¶ 4. The parties agreed that the Court's approval was to "contain provision for the payment and/or establishment of the escrow account from the sale proceeds with regard to the provisions herein set forth in paragraphs 1(b), 1(c), 3(b) of this Consent Order." *Id.*

Paragraph 3(b) states,

Freeport Shipbuilding's asserted pre-petition claim in the amount of \$350,000 shall be treated as follows: Upon the sale of the Speculator by the Trustee, the Trustee shall either (i) pay Freeport Shipbuilding \$250,000 in full satisfaction of Freeport Shipbuilding's \$350,000 pre-petition claims against BFG, BMDC and/or AMI, or (ii) pay Freeport Shipbuilding such amount of Freeport Shipbuilding's pre-petition modified assumption claim as the Trustee does not dispute and place

² On August 14, 1996, Freeport filed a proof of claim in the amount of \$738,018.22, to which the Trustee filed an objection on or about July 28, 1998.

³ As of October 8, 1998, the Speculator had not been sold.

the difference between that undisputed amount and \$350,000 in an interest bearing escrow account pending adjudication by the Court or such alternate dispute resolution mechanism as the parties agree. In the event that the Trustee opts to proceed under option (ii) of this subparagraph, both the Trustee and Freeport Shipbuilding shall be deemed to have reserved all of their rights under the Construction Contract and, under such reservation, Freeport Shipbuilding shall have the right to assert additional claims associated with the modified assumption of the Construction Contract, including, but not limited to, for lost profit and attorneys fees.

See id. at ¶ 3(b).

According to the Trustee, after the Speculator was transported from Freeport's facility, it was inspected by representatives of the Trustee in or about February 1997. Those inspections allegedly revealed that Freeport "had failed to furnish, supply or install materials and/or equipment in accordance with the Construction Contract, substituted substandard materials and equipment without authorization, and failed to complete specified work." *See* Trustee's Memorandum of Law, filed September 4, 1998, at 3-4.

Approximately a year later, on March 27, 1998, the Trustee commenced an adversary proceeding against Freeport by the filing of a complaint in which he seeks to avoid and recover alleged preferential transfers totaling \$350,000, and also seeks to recover damages based on alleged breach of contract, fraudulent concealment and conversion (Adv.Pro. 98-70474).⁴ Freeport in its Answer asserts a counterclaim seeking payment under the terms of the Contract, as well as an award of damages for lost profits and lost interest costs. It also seeks to recover attorney's fees associated with the assumption/rejection motion and the motion for administrative

⁴ The Trustee also filed a separate complaint against Freeport, alleging preferential transfers amounting to \$425,000 (Adv. Pro. 98-43399), which Freeport in its motion seeks to dismiss as being duplicative. Because the parties did not address this at oral argument, the Court makes no determination on that particular issue herein.

expense costs which were filed on November 5, 1996.

DISCUSSION

Although ¶ 3 of the Consent Order was referenced in Freeport's motion, the issue of Freeport's alleged waiver of its right to arbitrate claims arising under the Contract without the consent of the Trustee was not raised by the Trustee at the original hearing on September 10, 1998. The argument was first asserted by the Trustee in response to the Court's request at the hearing that the parties submit memoranda of law in support of their respective positions. It is the Trustee's position that under the terms of the Consent Order, unless both parties consented to arbitration, any claims arising out of the Contract are to be adjudicated by this Court.

It is important to note that the Consent Order was issued in an effort to resolve the three motions then pending before the Court. The Trustee wished to transport the Speculator from Freeport's facility, to which Freeport had no objection provided that the Trustee assumed the Contract and complied with the requirements of Code § 365.

Code § 365(b)(1) requires that at the time he assumes an executory contract or lease, the Trustee cure, or provide adequate assurance of a prompt cure of, any default. 11 U.S.C. § 365(b)(1)(A). In addition, he must compensate, or provide adequate assurance that he will promptly compensate, a party for any actual pecuniary loss to such party resulting from such

default. 11 U.S.C. § 365(b)(1)(B).⁵

Under the terms of the Consent Order, the Trustee and Freeport agreed that payment curing any default and compensating Freeport for any pecuniary loss would not occur until the Speculator was sold. Given this assurance, Freeport agreed to release the vessel to the Trustee. “Prompt” cure and compensation have not been forthcoming to date, however, because there has been no sale of the Speculator.

“In view of the ‘overriding federal policy favoring arbitration,’ waiver is not to be lightly inferred” *Sweater Bee by Banff v. Manhattan Industries, Inc.*, 754 F.2d 457, 461 (2d Cir. 1985), quoting *Carcich v. Rederi A/B Nordie*, 389 F.2d 692, 696 (2d Cir. 1968). The party seeking a finding that his opponent has waived a “conceded right to arbitration” has a heavy burden. *See id.* at 466. There is nothing in the Consent Order that expressly states that Section X of the Contract, which requires that disputes or claims arising out of the Contract “shall be settled by arbitration,” is waived. The Trustee directs the Court to ¶ 3(b) of the Consent Order in arguing that Freeport waived its right to arbitration without the consent of the Trustee. Paragraph 3(b) addresses the method for treating Freeport’s prepetition construction claim of approximately \$350,000 in the event of a sale, which was something not addressed under the terms of the original Contract. Among other things, it provides for the establishment of an escrow account into which is to be deposited a maximum of \$350,000 from the sale proceeds in the event that the Trustee disputes any portion of “Freeport Shipbuilding’s prepetition modified assumption claim;” otherwise, the Trustee agrees to simply pay Freeport \$250,000 in full

⁵ Since the Trustee required no future performance by Freeport under the Contract, Code § 365(b)(1)(C), which requires adequate assurance of future performance by the Trustee under the contract, was not a relevant consideration in executing the Consent Order.

settlement of its prepetition claim. It also grants Freeport a lien on the Speculator, which is to be released upon the Court's approval of a sale of the vessel.

Subparagraph 3(b)(ii) only becomes operative if there is a sale of the Speculator and if the Trustee disputes Freeport's claim and chooses not to pay it \$250,000 out of the proceeds of the sale of the Speculator in full satisfaction thereof. In this case, there has been no sale of the vessel, and, therefore, no election by the Trustee to pay Freeport anything from the sale proceeds. Under these circumstances, the Trustee should not be permitted to avail himself of ¶ 3(b)(ii) and must comply with Section X of the Contract, which requires that the parties arbitrate any issues arising out of the Contract, unless he is able to demonstrate that arbitration would conflict with the purposes of the Bankruptcy Code. *See In re U.S. Lines, Inc.*, 220 B.R. 5, 12 (S.D.N.Y. 1997) (citations omitted). Acknowledging that the Trustee's first of cause of action seeking to recover alleged preferential transfers is a core proceeding, Freeport takes the position that the allegations based on the prepetition contract are non-core and appropriate for arbitration. The Trustee argues that Freeport's claim for payments under the Contract, as well as an award of damages for lost profits and lost interest costs, is the same as that asserted in its proof of claim, to which the Trustee has filed an objection. The Trustee contends that granting Freeport's motion "would result in an arbitration panel determining core issues and making decisions which would unavoidably interfere with this Court's ability to coordinate the necessary reconciliation of the parties' competing claims." *See* Letter Brief at 4.

The Second Circuit Court of Appeals recently indicated that arbitration is to be viewed as a favorable means of reducing the cost and delays associated with litigation. *See Companiello Imports, Ltd. v. Saporiti Italia*, 117 F.3d 655, 665 (2d Cir. 1997). "While courts have disagreed

about how and whether to apply that standard in the context of core proceedings, there is a strong consensus that, in the context of non-core matters, bankruptcy courts are without discretion to deny enforcement of applicable arbitration clauses absent some showing that the text, purpose, or history of the Bankruptcy Code precludes enforcement of arbitration. *U.S. Lines, Inc.*, 220 B.R. at 13, citing *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149, 1156-57 (3d Cir. 1989)⁶; *Matter of National Gypsum Co.*, 118 F.3d 1056, 1066, (5th Cir. 1997); *see also In re Chorus Data Systems, Inc.*, 122 B.R. 845, 851 (Bankr. N.H. 1990) (stating that “there must be a demonstrated specific conflict between enforcing an arbitration clause and the textual provisions and/or purposes of the Bankruptcy Code to justify the exercise by a bankruptcy court in refusing to enforce an arbitration clause.” (citations omitted)).

“The fact that the matter before the court is a core proceeding does not mean that arbitration is inappropriate. The description of a matter as a core proceeding simply means that the bankruptcy court has the jurisdiction to make a full adjudication. However, merely because the court has the authority to render a decision does not mean it should do so. . . .” *In re Statewide Realty Co.*, 159 B.R. 719, 722 (Bankr. D.N.J. 1993). The focus should be on whether the action is one created by the Code for the ultimate benefit of all the creditors of the estate. *See id.* (emphasis added). If it is, then it is not appropriate for arbitration.

Freeport is not seeking to have the core matters involving alleged preferential transfers

⁶ In *Hays* the court concluded that enforcement of valid arbitration agreements was mandated by strong federal policy unless the objectives of the Code were in jeopardy. Trustee cites to *Wm. S. Newman Brewing Co., Inc. v. C. Schmidt & Sons, Inc.*, 115 B.R. 25 (N.D.N.Y. 1990) for the proposition that the Second Circuit has rejected the holding in *Hays*. However, a careful reading of the case makes it clear that other than noting that *Hays* was at most persuasive authority for the courts in this Circuit, Judge McCurn did not making any specific finding as to the merits of the case.

decided by an arbitrator. Citing to *Central Jersey Freightliner, Inc. v. Freightliner Corp.*, 987 F.Supp. 289 (D.N.J. 1997), Freeport suggests that the Court stay litigation of those matters pending arbitration. At the hearing held on September 24, 1998, the Trustee concurred with this suggestion and the Court agreed that the balance of the Trustee's complaint seeking to avoid certain alleged preferential transfers pursuant to Code §§ 544 and 550, as well as the balance of Freeport's counterclaim addressed to damages arising out of postpetition transactions and/or motions would be stayed pending the outcome of the arbitration.

The other claims of the Trustee, as alleged in his complaint, and those of Freeport, alleged in its counterclaim, arise from the Contract, rather than some provision of the Code. The fact that Freeport has filed a proof of claim does not represent a waiver of its right to seek arbitration under the terms of the Contract. *See Hart Ski Mfg. Co. v. Maschinenfabrik Hennecke, GmbH (In re Hart Ski Mfg. Co.)*, 711 F.2d 845, 846 (8th Cir. 1983); *see also Bender Shipbuilding & Repair Co. v. Morgan (In re Morgan)*, 28 B.R. 3, 5 (9th Cir. BAP 1983) (stating in *dicta* that “[e]ven if the defendant has made a claim against the estate, it may be appropriate to enforce a contract to arbitrate . . .”). While the Court may have authority to render a decision on the issues, Freeport's request that they be decided by an arbitrator has substantial merit when one considers the Court expertise, or lack thereof, to address whether, for example, the installation of a “bow thruster with straight mechanical shafts” was an appropriate substitute for a “bow thruster with a hydraulic drive.” A panel of neutral arbitrators with expertise in marine construction is certainly better able to examine the Contract and analyze any evidence provided by the parties' experts in this regard.

The Trustee has concerns with respect to discovery and suggests that “[t]he Trustee would

not have an opportunity prior to an arbitration hearing to assess Defendant's claims in light of documentary and testimonial evidence. Therefore, the Trustee is foreclosed from considering a resolution other than litigation or arbitration prior to such a hearing." In particular, the Trustee argues that he may need to subpoena non-party witnesses, which would not be possible in the context of arbitration. The Court notes that 9 U.S.C. § 7 does provide that an arbitrator, whether selected under that particular title "or otherwise," has the authority to issue summons to persons to testify at the arbitration hearing and in the event said persons refuse to obey the summons, the arbitrator may petition the United States district court to compel their attendance. At least one court has indicated that the parties themselves have no authority to subpoena nonparty witnesses and the arbitrator's authority is limited to requiring nonparty witnesses to appear at the hearing and not for pre-hearing depositions. *See Integrity Ins. Co. v. American Centennial Ins. Co.*, 885 F.Supp 69 (S.D.N.Y. 1995). The court in *Integrity Ins.* found, however, that the arbitrator did have the power to issue a subpoena to a nonparty requiring the production of documents prior to the hearing.

The Trustee indicates that the Contract's arbitration provision provides that any arbitration occur in Fort Walton Beach, Florida. Citing to Rule 45(b)(2) of the Federal Rules of Civil Procedure, the Trustee argues that any subpoena issued by an arbitrator pursuant to 9 U.S.C. § 7 would be enforceable only within the limits set for the district court where the arbitration is venued. One of the witnesses the Trustee alleges he wishes to call as a witness is a former employee of one of the Debtors who allegedly is outside the reach of the subpoena power of the arbitrator.

Freeport takes the position that the rules of arbitration are liberal and the parties have an

ability to agree to more formal discovery procedures then might otherwise normally be available. Freeport indicates that it has already stipulated on the record that it will cooperate in producing all evidence in its possession the Trustee wishes to review. Freeport is also willing to exchange expert opinions in the context of the arbitration. Whether Freeport would also agree to having the arbitration conducted in some other location than Fort Walton Beach, Florida, as originally agreed upon under the terms of the Contract, is unknown. Certainly, the problem raised by the Trustee with respect to the subpoena of out-of-state nonparty witnesses in the context of an arbitration hearing is not one unique to this case. The Court does not believe it should serve as the basis for denying Freeport's motion, particularly in light of the federal policy favoring arbitration. *See Shearson/American Exp., Inc. v. McMahon*, 482 U.S. 220, 227, 107 S.Ct. 2332, 2337-38, 96 L.Ed.2d 185 (1987).

The Trustee has failed to establish any fundamental policies of the Code that would preclude sending the breach of contract causes of action to arbitration. Merely hypothesizing that there may be a need to subpoena certain nonparty witnesses does not appear to meet that burden. Therefore, the Court concludes that Freeport's motion, to the extent that it requests that the prepetition contract claims and counterclaims be sent to arbitration, should be granted.

IT IS SO ORDERED.

Dated at Utica, New York

this 29th day of October 1998

STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge

